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A CASE FOR CHANGE

FMCG: Winning the commercial battle in emerging markets

A Case For Change

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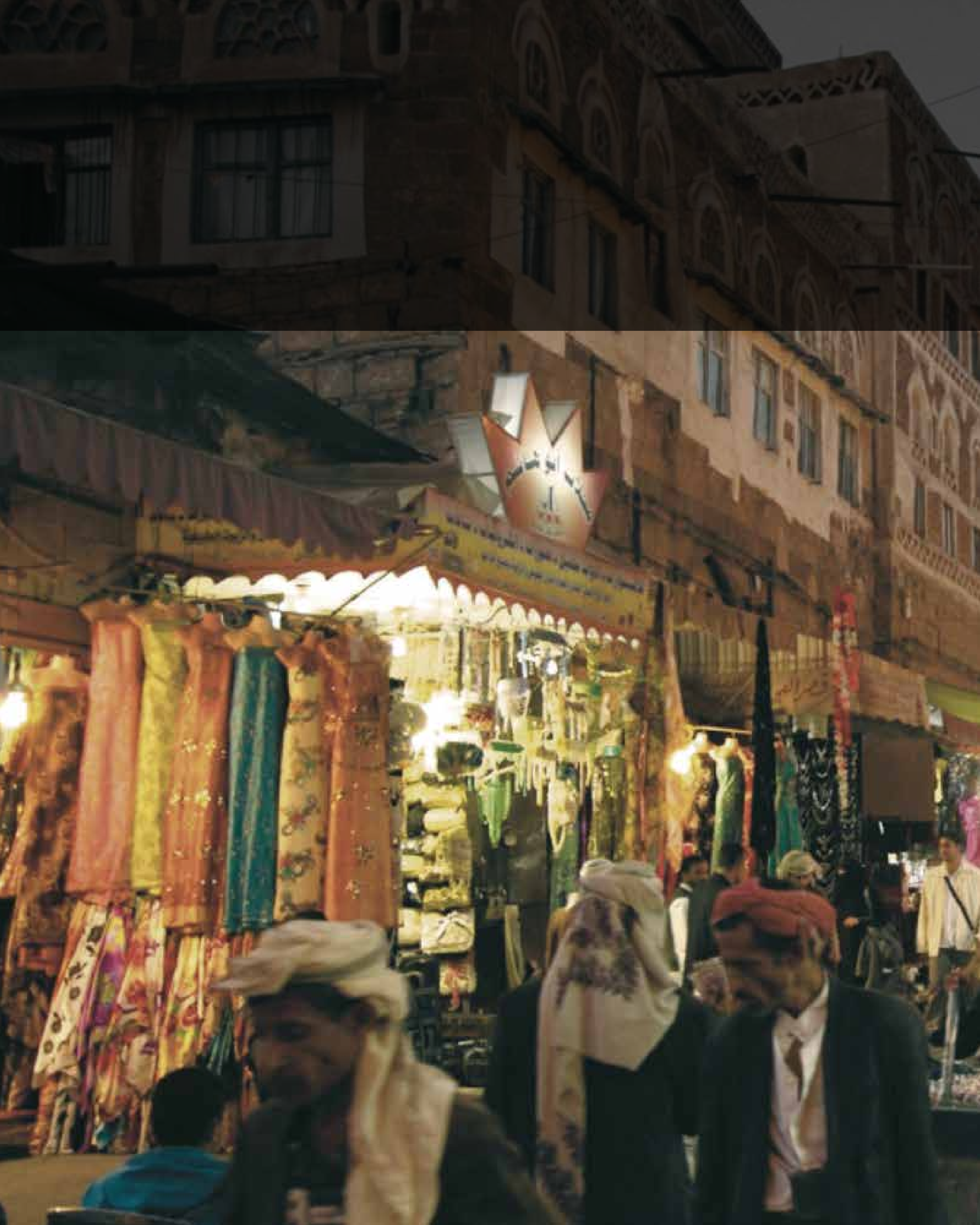
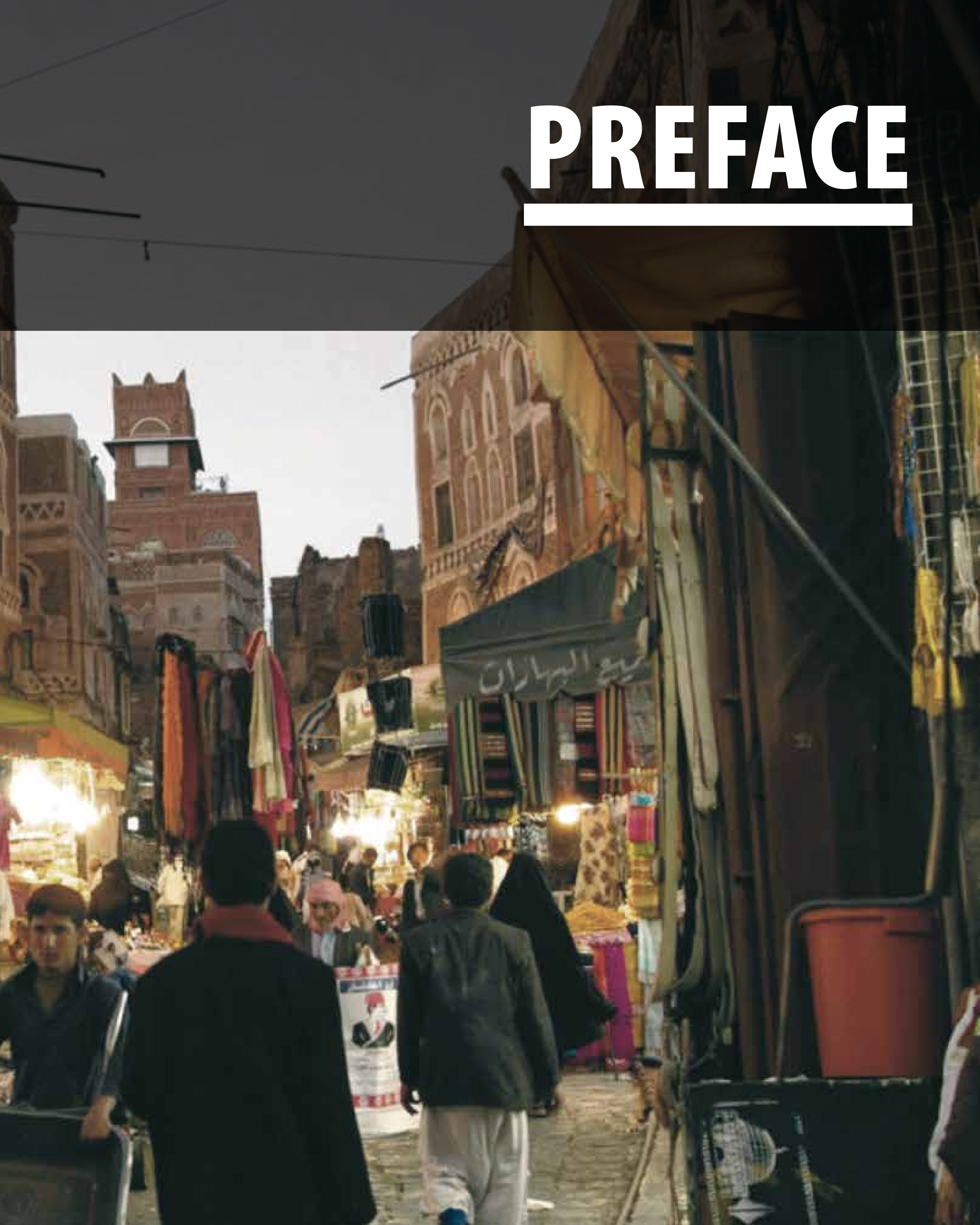


PREFACE



»Someone‘s sitting in the shade today because someone planted a tree a long time ago.«

— Warren Buffett

CASE FOR CHANGE is a textbook from practitioners for practitioners. The author has a commercial track record of working with global *Fast Moving Consumer Goods* (FMCG) companies in more than forty countries, most of them developing or emerging countries.

Designed to meet the needs of business school students, as well as of those who already work in the consumer goods industry, this book provides insights into the operational procedures of several globally operating *consumer packaged goods companies* (CPG) that have managed to succeed in these markets over and over again. Complementing brand marketing, a scientific approach to commercial planning and commercial execution continues to be today's driving force behind sustainable profitability, even in markets with low purchasing power.

This book forms the foundation of the CASE FOR CHANGE program. This program is designed to complement the content of this book with additional examples and how-tos through Business school lectures and a series of webinars for self-training.

QR 1

QR 2

QR 3

In 2020, emerging and developing markets will represent about 70% (QR 1) of FMCG' sales and profits (see fig. 1).

Future FMCG growth will primarily be driven by the growth of urban populations in emerging countries. In 2020, about 60% of the top 600 cities will be located in emerging countries (QR 2) and 735 million households, or 1.3 billion consumers (QR 3), will belong to the new middle class that can afford to consume global brands.

For FMCG companies of various sizes, revenue and profit distribution has already started to shift in favor of developing and emerging markets.

This book sets out to provide the specific commercial skills required to succeed in these markets based on the author's many years of experience in senior commercial roles at global FMCG companies.

Whereas global players have sufficient resources to capture and disseminate commercial learnings into new markets, smaller players often have different structures and less formal capacity building opportunities to be applied to markets of the future.

This book is designed to help small and medium sized FMCG companies with international brands to succeed commercially in these important future markets.

One may be inclined to think that making branded products available as fast as possible by using local distribution partners or wholesalers may be the way to success, but this is short-term thinking.

While speed to market and ubiquity are important, experience has shown that building a basic understanding of the right commercial planning and execution within the own local organization and among commercial partners on site will help companies to grow profitably – once the first battles are won!

Studying companies that have a history of commercial success in these markets, as well as a long learning curve, will allow smaller companies to succeed.

This book proposes a commercial framework of operational and strategic planning and execution that builds on publicly available business cases of the past ten to fifteen years. These cases illustrate the commercial success that global FMCG companies, such as Procter & Gamble, Unilever, Coca-Cola or Nestlé, have had in developing and emerging markets.

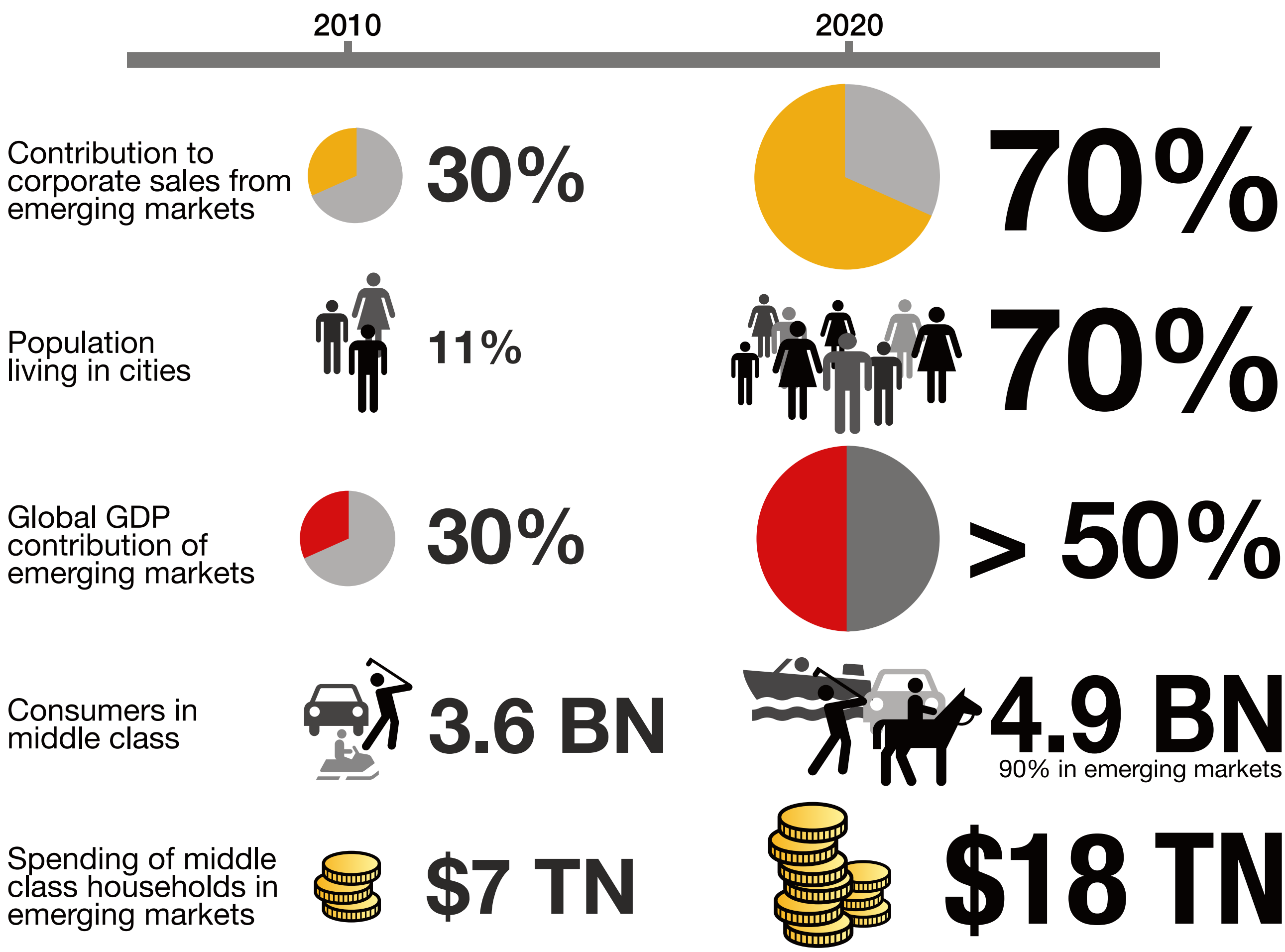


Fig. 1 — Over time

TECHNOLOGY, LANGUAGE AND MOBILITY

Technology, language and increased mobility globalize all businesses. Simple, electronic communication available 24/7 and in one single language, English, has become the norm. In addition, global IT solutions, such as SAP and Oracle, have become implemented across the world.

Global infrastructure and improved local education levels, combined with the ease of communication, have enabled globally operating companies to learn and disseminate learning swiftly across their different geographical locations. Against the backdrop of these developments over the past ten years, even the most local commercial exchanges have started to become as globalized as other business functions before.

However, even for global brands, it is still true that all business is local and that consumer needs continue to vary significantly from one geographical location to another.

In spite of this, most successful global Consumer Packaged Goods (CPG) companies have built a commercial muscle that can be applied immediately to all new markets to improve commercial performance locally.

Furthermore, improved high bandwidth communication technology, lower cost of travel and improved global language capabilities have led to a dramatic increase in global mobility of associates within large consumer goods manufacturers.

The learning curve, experienced when moving into a new market, is significantly less steep today. Therefore, the exchange of talent has become easier and more frequent, even on the lower middle management level. Developing and emerging countries have greatly benefited from importing and exporting talent.

The ability to connect anytime and from anywhere, as well as higher talent mobility, has helped developing and emerging markets to catch up and even surpass commercial capabilities of developed markets, such as the U.S. or Europe.

This book is specifically designed to help FMCG companies of a smaller scale that have a smaller library of corporate learning or less resources dedicated to building and distributing commercial skills. The goal is to expand their commercial planning and execution capabilities.

This book focuses on developing and emerging markets. For lack of a widely recognized definition, the terms developing or emerging markets are used when referring to a group of markets outside of affluent developed markets. For the past fifty years, developed countries have dominated the global economy. In spite of accounting for only twenty percent of the world's population, developed countries have contributed about 70-80% of global income. A situation that will likely change over the next twenty years, as will be discussed in the next section.

SEVENTY PERCENT OF GROWTH

QR 4

QR 5

QR 6

Among business leaders, as well as politicians there is a common understanding that FMCG companies' main source of growth over the next twenty years (QR 4) will come from developing or emerging markets.

Bain Consultancy states that by 2015 (QR 5) markets like China, India, Brazil, Turkey will contribute approximately 60% of global GDP and 60% of retail growth. In contrast, today five markets make up 30% of global GDP (U.S., UK, Canada, France, Germany).

Citing from a recent McKinsey report (QR 6):

> *»Over the past ten years fifty key categories of FMCG grew by 5% annually to reach seven trillion Dollars. Spending in emerging markets will drive the expected increase in consumer spending worldwide. By 2020, emerging markets will represent close to 50% of total consumer spending and about 70% of the overall growth in consumer spending from 2010 to 2020.«*

URBAN AREAS: THE NUMBER ONE DRIVER OF GROWTH

QR 7

Today, only six hundred urban centers worldwide generate about 60% of global GDP. Their contribution will remain unchanged, but the composition and location of these cities will shift towards the South and – even more decisively – the East. By 2020, roughly 70% of the world's population (QR 7)will live in urban areas.

MIDDLE CLASS HOUSEHOLD

QR 8

QR 9

There is no uniform way of defining a middle class household (QR 8). According to one narrow definition, the middle class includes all households with an annual income above $31,000 PPP (Purchase Power Parity adjusted, QR 9) or a daily income of about $85.

Milanovic and Yitzhaki developed a more popular definition, which holds that the *global middle class* starts at an annual income of only $4,000 (in $ PPP of 2005).

Conservatively estimated there were 3.6 billion middle class consumers in developing countries in 2010. This number is expected to grow by an additional 1.3 billion consumers by 2020, that is, 250,000 to 300,000 new middle class households per day. (See fig. 1).

QR 10

More recent studies (QR 10) that base their estimates on cars in circulation even indicate that the number of current middle class households is 50-60% larger.

QR 11

Although middle class consumers in developing and emerging countries are still considerably poorer than their counterparts in advanced economies, their vast number and increasing ability to devote more of their income to consumer goods will grow the market enormously. It has been estimated that middle class households will spend an additional 10 trillion dollars by 2020 (QR 11).

SOURCE OF PROFIT

Today, global FMCG, such as Unilever, Coca-Cola, Gillette, Nestlé and Colgate-Palmolive, generate one third or more of their revenue from these markets, with profitability being equal to, or higher than, what they achieve in developed economies.

QR 12

For example, the Coca-Cola Company now derives 37% of its revenue (QR 12) from Latin America, Africa and Asia, and these markets contribute a stunning 49% to Coca-Cola's operating profits. Similarly,

CASE FOR CHANGE

»In a world where populations are growing, where natural resources are stressed, where communities are forced to do more with less and where consumers' expectations are expanding, sustainability is core to our business continuity and survival.«

— Muhtar Kent,
The Coca-Cola Company, 2010,
QR 14

QR 14

SUPPORT BROADER TARGETS

This book describes world-class commercial work. However, commercial work is only one of multiple functions in most FMCG companies. Commercial planning, as the author would like it to be seen, works side-by-side with other critical functions, such as marketing, finance, human resources, manufacturing and sales.

This book furthermore assumes that any fast-moving consumer good company, typically needs to satisfy a variety of stakeholders:

- Shareholders;
- Employees;
- Communities and environment, in which the company operates;
- Customers of this company.

This book demonstrates how the commercial function supports the growth of traditional targets of any company, such as revenue, share and ROIC. This helps fulfill shareholder expectations.

All large companies and organizations, irrelevant of their industry and irrelevant of their profit or non-profit status, have to assume responsibilities that go beyond traditional targets.

QR 15

- Sustainability: A company only acts responsibly and sustainably if business is conducted in an environmentally friendly way. A great example of a sustainable company is the Coca-Cola Corporation. Together with the World Wide Fund for Nature (WWF), this company has implemented a water neutral principle (QR 15), pledging to return as much water to the world as it uses;
- People: Everything an organization does has to improve the living conditions of its employees, customers and consumers, as well as benefit the communities in which business is conducted;
- Community: The responsibility of benefiting these communities includes: enhancing the well-being of the people, improving access to natural resources and stimulating economic growth. Good examples of such community development

QR 16

projects are Coca-Cola's Ekocenters (QR 16) or mini one-stop shops that will supply cooked meals, clean water, power, Internet, vaccines and beverages to twenty developing countries.

In many multinational companies, the commercial function contributes to these targets just as much as to traditional economic targets.

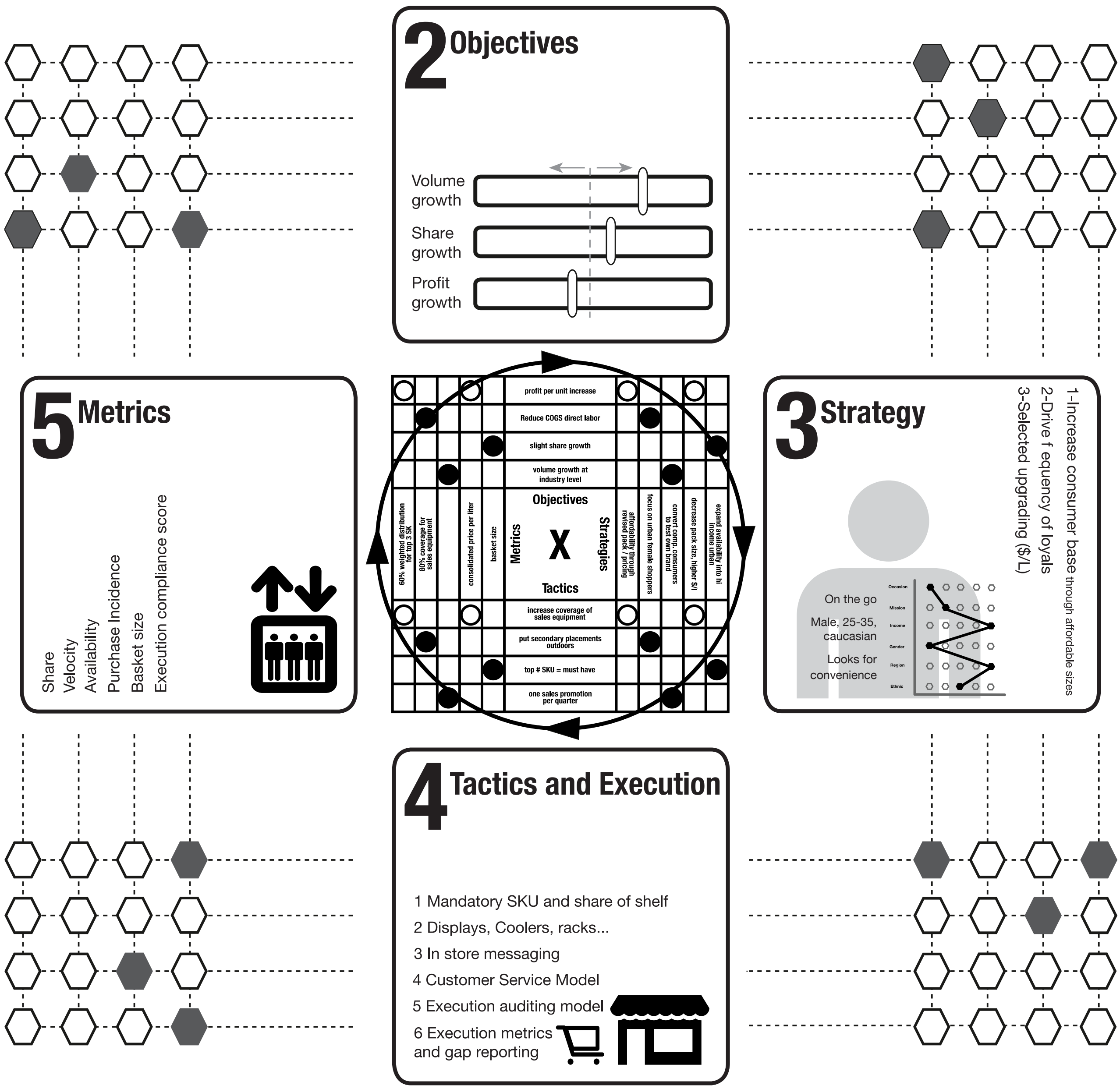


Fig. 2 — The Closed Commercial Loop™

INTRODUCTION

A Case For Change is divided into six chapters. In sequence, this book describes five interconnected commercial disciplines, which together are called the Closed Commercial Loop™ (see fig. 2). Before describing each of the chapters and the suggested workflow, the scope of planning will be defined.

PLANNING SCOPE

Two dimensions define the scope of commercial planning:

- Short-term versus long-term — is it a one-year operational plan or a three-year strategic plan?
- Granularity of planning.

SHORT-TERM AND LONGER-TERM

Longer-term planning, which this book defines as three-year strategic planning, takes place primarily on the top level, i.e. the national level. Short-term and long-term plans — both include specific disciplines. Compare Table 1, which maps out elements of short- and long-term planning in relation to each of the chapters of this book.

WORKING LEVEL

Chapter One determines the number of market segments for which planning and execution work is done. Segmentation, therefore, determines the working level and the amount of planning work.

- Default working level for the purpose of this book, refers to channel by category and is based on the author's commercial experience in over thirty countries (i.e. breakfast cereals in small traditional grocery stores)
- Top level refers to the national level
- Bottom level is SKU by (sub) channel.

THE TASTE COMPANY OF »EMERGIA«

The fictitious country of »Emergia« (somewhere in Central Asia) and a local subsidiary of »The Taste Company« (TTC), a global player in ice cream, serve as examples throughout most chapters in this book.

All data relative to TTC is purely illustrative, while, at the same time, the TTC case serves as a good representation of commercial situations that consumer goods companies would likely face in emerging markets. The TTC case demonstrates how processes, data and tools should be utilized to create meaningful and tangible outputs for each of the chapters in this book.

QR 17 PDF

QR 18 Excel

TTC examples and exercises all utilize information summarized on a one-page fact sheet, which the reader is suggested to download (Download fact sheet as PDF, QR 17, or Excel file, QR 18).

Emergia is a central Asian market with single digit GDP growth rates and stagnating net-income growth. During the first couple of years, availability increases stimulated consumption, but now per capita consumption is not growing as strong anymore.

»The Taste Company« focuses on various categories within consumer ice cream and other related product categories. TTC's competitive advantage, both in brand strength and production technology, lies within a unique form of soft ice.

The current per capita consumption of TTC branded ice cream is five portions, meaning five consumptions annually of a 50g personalized ice cream portion.

TTC, Emergia reports to TTC's regional headquarters for Central Asia, where brand marketing and many other business functions are concentrated for the various markets in the region. However, there is no regional commercial function and, as a result, TTC Emergia has the license and obligation to act independently.

After having been four years in the market, TTC is now planning for its fifth year in Emergia.

When TTC entered the market, they became market leaders within six months. Since then many local manufacturers with much lower cost structures have used fast copy/paste launches to enter the market. Now, TTC's revenue share is tied with their number one competitor, »EM foods«.

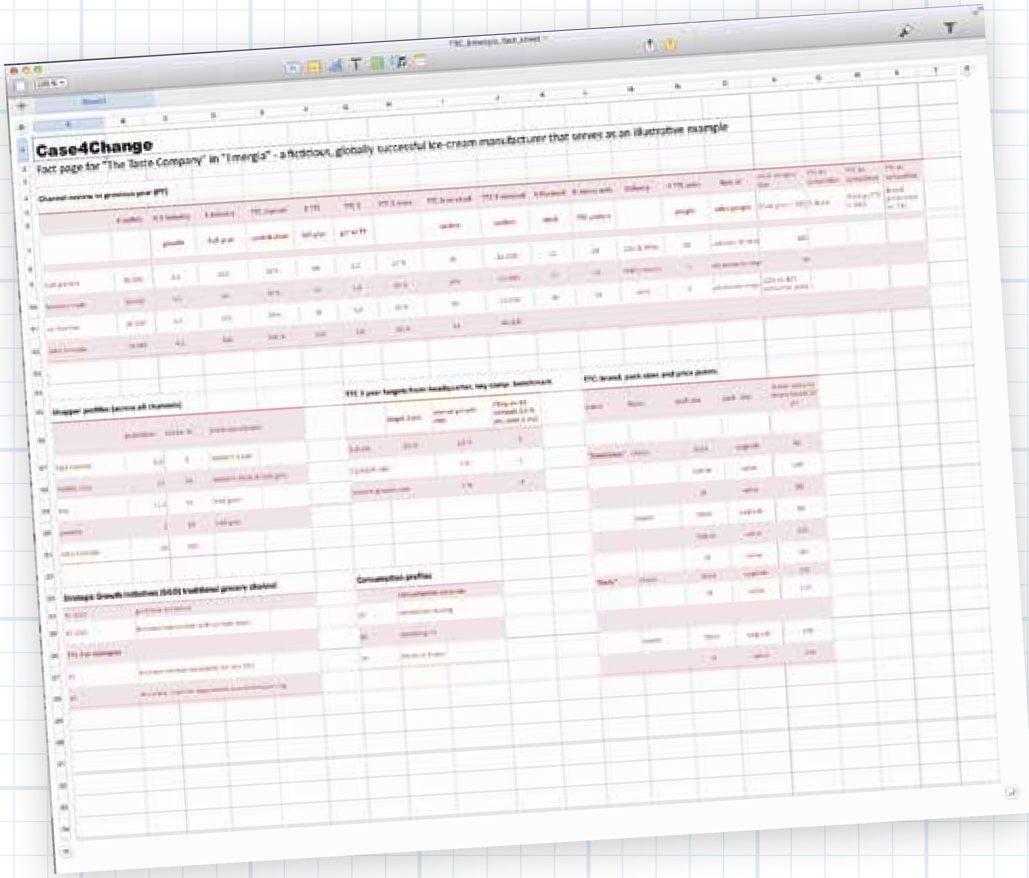
TTC's top brand "Daily" has brand preference scores 20% up in comparison to »EM foods« brands. Daily average consumer pricing is at a 25% premium against »EM foods«.

TTC has a tradition and an expectation to defend market leadership and to build a sustainable, profitable business in Emergia.

During the first four years, TTC over-invested in its key brand and in commercialization. For the upcoming planning period, the profit and loss parameters that have been agreed upon with the regional headquarter are as follows:

- Gross profit: 50% of net sales;
- Marketing / Commercial budgets: 8% of net sales;
- Operating profit target: 10%.

Based on the TTC case, this book will establish the foundation of a one-year operational commercial plan, leveraging the data provided in the fact sheet and applying the tools from the textbook.




Jif

SEGMENTATION

»Cause division among them. Attack when they are unprepared, make your move when they do not expect it.«

— Sun Tzu

SEGMENTATION: A STRATEGIC WEAPON

Segmenting, or dividing the market, reduces a common risk of manufacturers of mass or commodity categories, namely:

- The gradual decline of profit margins as competition increases and
- Copycats take share.

This chapter consists of the following parts:

- Segmentation as the base for differentiation;
- Degree of segmentation;
- Potential conflict between segmentation and horizontal or vertical growth strategies;
- Potential downsides of segmentation;
- The how-to of segmentation;
- Requirements for good segmentation;
- Data sources.

QR 19

As Michael E. Porter states in What is Strategy? (QR 19):

»A company can outperform rivals only if it can establish a difference that it can preserve. It must deliver greater value to customers or create comparable value at lower cost, or both. [...] Delivering greater value allows a company to charge higher average unit prices.«

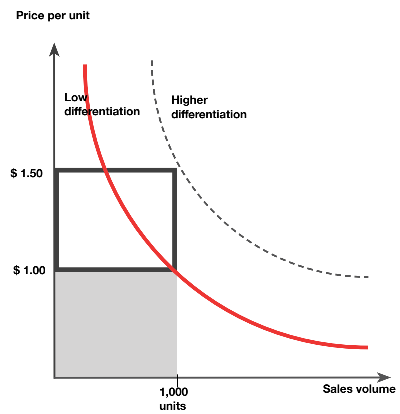


Fig. 4 — Volume and profit

Differentiation, when well planned and executed from a marketing and commercial side, leads to:

- Higher average prices per unit (see fig. 4: Volume and profit);
- Decreased vulnerability to economic downturns;
- Long-term competitive advantages.

Segmentation is the base and the key enabler of differentiation. It is a continuum from zero (no differentiation, same offer everywhere) to infinite (every consumer gets a tailor made product, i.e. in tailoring). Also see fig. 5, which displays a typical evolution of market segmentation.

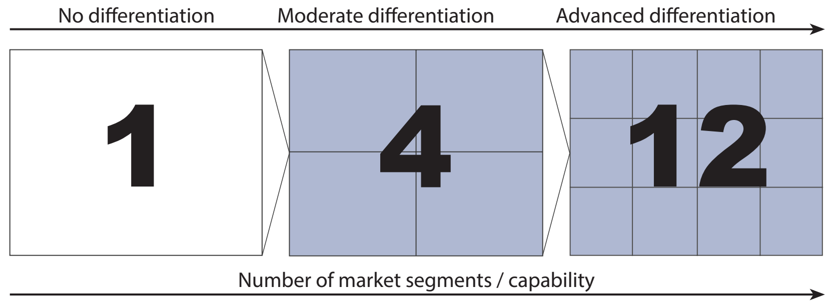


Fig. 5 — Continuum of segments

More practically: the total market is broken down into segments or clusters, each addressing needs that are sufficiently different from each other. See fig. 6.

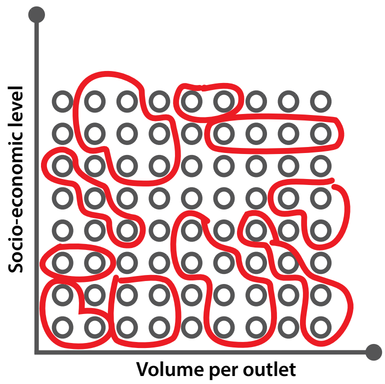


Fig. 6 — Segmentation principle

Differentiation in this book is used to describe the practice of offering IDENTICAL product quality (i.e. fresh milk) at DIFFERENT price points and/or in different packaging and different shopper messaging to meet the needs of different shoppers and consumers in distinct segments.

Successful FMCG manufacturers are typically thriving of offering Differentiated Mass Products. Even in emerging markets, however, volume growth rates decline over time, as more and more competitors enter the market. Successful companies take the following steps to prevent this phenomenon: they build capabilities in times of steep volume growth, so that they can later increase their degree of pack/price differentiation, which in turn allows them to charge higher prices per unit, and thus creates incremental profit.

In addition to Michael E. Porter's teaching, all experience shows that differentiation leads to a strategic competitive edge and a culture that CPG manufacturers need to implement at an early stage in emerging markets. Only if the organization and its business partners have gradually built capabilities over years, then differentiation is an available strategic weapon once volume growth slows down or higher-income clusters appear in emerging markets.

As part of its three-year strategic plan, every FMCG company should review its balance of increased complexity, capabilities and level of differentiation. Most successful companies have gone through a seven- or eight-year journey of developing a sophisticated segmentation, starting with three segments initially and ending up with 60+ segments.

NOTE

The terms segments and clusters are used interchangeably in this book. A market can be defined as one country or multiple. The terms cluster and sub-channel are also used interchangeably, describing a set of customers within a specific (sales) channel.

DEGREE OF SEGMENTATION

The degree of segmentation (see fig. 7) depends on:

- Product category: some products (i.e. like flower, fuel, sugar, paper towels) do not lend themselves to a strong degree of differentiation;
- Consumer price elasticity: the more generic a category, the more elastic consumer demand. Differentiation becomes more challenging with high elasticity;
- Capability to develop differentiated packaging (works less well with products such as energy);
- Number of different consumption situations, where the same product quality is being used (i.e. coffee has many different consumption occasions, detergent has only one);
- Ability to plan and execute differentiated offerings. Typically, the higher the degree of DSD (Direct store delivery), merchandising and in store activation, the higher the capabilities for segmented execution. The ability to adopt the Customer Service Model and to manage service costs is an approach (sales, distribution, activation) to market needs and to manage GoToMarket costs is a critical enabler for segmented execution.

POTENTIAL CONFLICTS AND DOWNSIDES

In Chapter Three, strategies will be divided into horizontal and vertical strategies (see fig. 24).

Horizontal strategies expand distribution into additional channels or outlets, whereas vertical strategies summarize all measures to grow same store sales in existing distribution. As segmentation is a key enabler for any vertical growth strategy, the relationship and potential trade-off between horizontal growth and segmentation should be explained.

Whereas vertical growth strategies build on segmentation (hence, very targeted activation), horizontal growth strategies require a one-size-fits-all offer to maintain the ability to expand and grow rapidly.

The benefits of segmentation are clear, but segmentation does come at a price:

- Overall increased business complexity;
- Higher number of pack or price variations;
- In-store activation or messaging variety grows with the complexity of pack/price variations;
- More time required with customers, more specialized customer service models may be required;
- More challenges in product delivery;
- Smaller production runs / reduced line utilization.

REQUIREMENTS FOR GOOD SEGMENTATION WORK

The objective of any segmentation work is to determine a number of segments that are sufficiently different in the sense that this difference is:

- Actionable (in store, customer service models);
- Sustainable (difficult to copy in a short time, financially scalable);
- Consumer and shopper relevant;
- Incremental profit exceeds incremental execution and other complexity costs.

Segmentation work, as it will be described later in this chapter, typically generates a very high number of segments at first. These then need to be consolidated to meet the capabilities of execution.

POTENTIAL SEGMENTATION CRITERIA TO CONSIDER

The previous section showed what "smart" segmentation looks like. Any segmentation requires equally smart criteria or perspectives by means of which to divide the market. A list of typical segmentation criteria are (see also fig. 8):

- Geographies, cultural differences, taste preferences;
- Retail channels;
- Retail size or store revenues;
- Socio-demographic data, incl. ethnics;
- Consumption occasion – why is a product purchased;
- Shopping Missions;
- Logistic infrastructure (i.e. availability of warehouses, roads, trucks in urban areas)

The most granular commercial segment would be a micro segment (i.e. one street, one house).

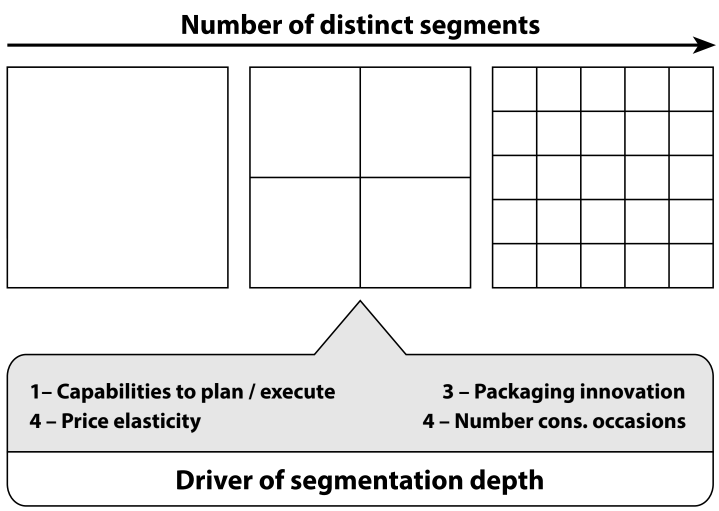


Fig. 7 — Degree and depth of segmentation